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E-Commerce and State Protectionism

by
Michael Mallinger

The Commerce Clause of the United States Constitution, which empowers Congress to regulate commerce among the several states, was intended to prevent states from erecting barriers to trade. State laws that discriminate against out-of-state products or destroy the unity of a national market to reap local benefits have been found unconstitutional, a doctrine which is known as the “dormant commerce clause.” The courts have recognized that state regulation of the Internet is especially problematic under the dormant commerce clause, because the Internet is not only a national but an international network.¹

Background. As firms that sell products or services over the Internet push into new industries and markets, their old-line rivals are fighting back. One tactic is to use dubious “consumer protection” arguments to urge state legislators to attack the use of the Internet to move goods across state lines. Another is for regulators to apply existing consumer-protection laws, which suppress competition to the Internet. The efficacy of these laws in protecting consumers is questionable, but their result of limiting consumers’ choices and forcing them to pay higher prices is certain.

On-line wine sales. Restrictions on the interstate sale of alcoholic beverages are products of the Prohibition Era. The 21st Amendment to the US Constitution (repeal of prohibition), enacted in 1933, specifically prohibits the “transportation or importation” of liquor into a state in violation of the state’s laws, a provision originally intended to give “dry” states the power to maintain that status. (Without such a provision, the Commerce Clause of the Constitution might well have compelled all states to permit alcohol sales.)

No state is now totally dry, but the power is still being used, primarily to protect in-state liquor monopolies and state tax revenues. Thirty-three states restrict direct shipments of alcohol from out-of-state on-line retailers or direct-mail operations to customers.² In seven of these states, the offense is a felony. Penalties can be stiff; New York violators face a fine and jail time of up to one year.³ In

addition, the Twenty-First Amendment Enforcement Act, passed by Congress in October 2000, enables a state to get a federal civil injunction against an out-of-state company that makes shipments into the state.⁴ It does not expand the substantive authority of existing laws, however.

These restrictions on direct shipment impose serious costs on wine sales. Customers in states that forbid direct shipments must purchase their wine from state-licensed wholesalers. In some states, Massachusetts for example, liquor licenses are limited in number or by other restrictions;⁵ in about 17 states (the number is dropping in the face of privatization initiatives) the state itself owns the liquor stores.⁶ Either approach results in higher prices for consumers.⁷

Prohibitions on direct shipment also deny customers access to many of the products offered by the nation's 1,600 wineries. Consumers must either request that a wholesaler in their state special order out-of-state products at a markup rate of up to 25 percent, or they must visit the out-of-state retailers themselves. Meanwhile, small wineries languish because their wines may not be carried by major liquor distributors, and because they lack access to a nationwide market. The typical retail store handles wines from only about 50 wineries.⁸

Ostensibly, restrictions are designed to prevent the sale of alcohol to minors. But states have another powerful incentive—protecting state revenues. During 2000, Texas collected \$5.4 billion in tax revenue from the sale of wine.⁹ Also, wholesalers have considerable political power, and this muscle is used to protect their competitive turf. The biggest wholesaler, based in Miami, has annual revenues of \$2.3 billion, which is seven times the \$300 million annual nationwide total of direct wine shipments.¹⁰

The Supreme Court found in *State Board of Equalization v. Young's Market Co.*, that the 21st Amendment gives states *carte blanche* to deal with liquor as they choose.¹¹ However, a later case, *Hostetter v. Idlewild Bon Voyage Liquor Corp.*, said the conclusion that the 21st Amendment “has somehow operated to ‘repeal’ the Commerce Clause” with respect to liquor would be “an absurd oversimplification.”¹² Subsequent decisions have extended this theme, making it clear the 21st Amendment is not a license to discriminate against out-of-state products because “the central purpose of the Twenty-first Amendment was not to empower states to favor local liquor industries by erecting barriers to competition.”¹³

Using these cases, wine lovers and wineries are fighting against the restrictions, coordinating their efforts through organizations such as Free the Grapes, the Coalition for Free Trade, and the Wine Institute.¹⁴ Recently, they have collected appellate-court victories in Florida and trial-court wins in Massachusetts, Texas, Illinois, and Indiana.¹⁵ The Institute for Justice has challenged a law in New York, second only to California as a wine market, that permits in-state wineries to advertise and ship to consumers but forbids comparable activities by out-of-state wineries. A US district judge recently denied a state motion to dismiss the case, using language that seems to presage another decision against restrictive laws.¹⁶

Automobiles. About 40 states have enacted franchise laws that prohibit direct sales of new cars by manufacturers across state lines.¹⁷ Most states also limit the number of dealerships that can sell new cars within their borders.¹⁸ Many states have “Relevant Market Area” laws. These laws provide existing dealers with a regulatory forum to object to, and perhaps prevent, the opening of a new dealership within their local market. The laws also allow protests against an existing dealer trying to expand or to build an innovation such as a service center into his dealership.

Manufacturers had planned to establish on-line outlets for their vehicles, partly to offer innovations such as “no haggle” pricing. Ford and General Motors scrapped their plans to sell directly to consumers, under heavy pressure from existing dealerships waging a nationwide campaign.¹⁹ Ford’s Texas website did not sell directly to consumers, but instead offered information about prices and options, referring the customer to local dealers for the sale. Even so, dealerships participating in these partnerships with Ford were threatened with a \$10,000-per-day fine.²⁰ Recently, the manufacturers have been trying to make a deal with their dealers. A new website, FordDirect, which will offer a price somewhere between the invoice price and the manufacturer’s suggested retail price, is 80 percent owned by dealers, 20 percent by Ford.²¹ The Internet also creates the promise of huge virtual used-car lots like CarsDirect.com; these companies are affected mainly by state laws that ban the “brokering” of cars or require that brokers be licensed.

Even before their application to the Internet, automobile franchise laws imposed unnecessary costs on consumers. An FTC study found that “Relevant Market Area” laws raise prices, sometimes by up to 25 percent.²² Some franchise laws are being challenged in the courts. For example,

Arizona's bans on on-line sales, on on-line direct manufacturer referrals of leads for new sales, and on manufacturer financing of buyers who make purchases independently of local dealers are being challenged.²³

Inhibitions on competition and escalation of costs has nothing to do with protecting consumers, and everything to do with protecting the profits of automobile dealers. The structure of restriction is built on two Supreme Court cases from 20 years ago. *Exxon Corp. v. Governor of Maryland*²⁴ upheld a law forbidding ownership of retail gasoline stations by integrated oil companies, and *New Motor Vehicle Board of California v. Orrin W. Fox Co.*²⁵ upheld a scheme that allowed existing auto dealers to prevent the establishment of competing dealerships.

Given the increasing protectionism evident in state laws since *Exxon* and *Fox*, plus the potential gains for consumers created by the Internet and obstructed by these laws, it is inevitable the Supreme Court will be called upon to revisit the constitutionality of these restrictions.

Cigarettes. Although state restrictions on on-line cigarette sales have not faced the same level of scrutiny as restrictions placed on wine, courts have been more willing to strike down these laws under the dormant commerce clause because there is no 21st Amendment giving the state special power over cigarettes. In November of 2000, a federal district judge issued a temporary restraining order preventing a New York ban on the direct sale of cigarettes via the Internet from taking effect, concerned that the law violated the Commerce Clause.²⁶ She stated that "the papers do not demonstrate that the state's interest in improving adult health by decreasing smoking will be achieved by this statute."

Policy recommendation. State restrictions hindering the expansion of electronic commerce harm consumers. They raise prices and reduce consumer choice. They also hurt small businesses whose only chance to reach a national market may come through the Internet.

The argument that restrictions are necessary to prevent minors from obtaining alcohol and cigarettes on-line is not enough to justify a ban on interstate liquor sales. On-line retailers already try to exclude minors. The American Vintners Association has created a new website called creditcards.com that enables retailers to verify customer ages without violating privacy.²⁷ Although a minor might circumvent this restriction by borrowing a parent's credit card, the development of electronic signatures under the Global and National Commerce Act could resolve this issue.²⁸

Likewise, the argument that local automobile dealers can best offer trustworthy, long-term relationships to car purchasers should not be allowed to prevent consumers from having a larger range of choices. If consumers find local dealers better, they will buy from them; if they do not, then why should they?²⁹ Furthermore, on-line car outlets will be able to contract with service centers in the customer's area to arrange for cars to be serviced, and many consumers would be reassured by the knowledge that the seller is exercising continuing supervision over the service outlet.

Realistically, in a highly mobile society, a local dealer may assume a customer will move before he needs a new car, and has little incentive to invest in the relationship. Conversely, a manufacturer which sells nationwide has strong incentives to make the ownership experience pleasant.

Hopefully, the courts will invalidate these protectionist laws and reaffirm the validity of the Commerce Clause; judges analyzing these issues have done a good job so far. Congress might also step in where state legislatures face "capture" by influential groups such as automobile dealers in ways that significantly inhibit interstate commerce. The fact that the United States is one big common market has brought us incredible benefits. We should keep it that way.

~ MICHAEL MALLINGER

¹ See *American Library Association v. Pataki*, 969 F.Supp. 160 (S.D.N.Y. 1997)(New York law regulating speech considered "harmful to minors" on the Internet violates the interstate commerce clause), as well as *Cyberspace v. Engler*, 55 F.Supp.2d 737 (D.C.Mich. 1999)(striking down Michigan law regulating the distribution of obscene speech on-line to children).

² The Wine Institute website, www.wineinstitute.org/shipwine/analysis/intro_analysis.htm, has a summary of state wine-shipment laws. Twelve states allow interstate shipments by wineries from states that reciprocate; 10 allow some shipping under other circumstances; 17 have no restrictions; 30 states allow direct shipment by in-state wineries. Wine is treated somewhat more permissively than other types of alcohol.

³ Declan McCullagh, "Wineries Offer Boos to NY Laws," *Wired News*, 2 February 2000; available at www.wired.com/news/print/0,1294,34126,00.html.

⁴ Twenty-First Amendment Enforcement Act, S. 577, H. R. 2031, introduced 10 March 1999. The final version of the bill was passed in October 2000 as part of H. R. 3244, Victims of Trafficking and Violence Protection Act of 2000; available at thomas.loc.gov. See Scott Rosenberg, "Keep The Customer Dissatisfied," *Salon*, 20 October 2000; available at www.salon.com/tech/col/rose/2000/10/20/customer/print.html. The act also requires that the Justice Department carry out a study to determine the effects of its enforcement procedures on alcohol purchases by minors.

⁵ Tony Munroe, "Markets Eye Liquor License Law," *The Boston Herald*, 17 June 1998.

- ⁶ Joseph L. Bast and Carolyn Bast, "A Taxing Matter: Changes in Government Revenue and Spending Priorities, 1950-1996," *Heartland Institute Policy Study* (1997).
- ⁷ Julian L. Simon and David M. Simon, "The Effects of Regulations Upon State Liquor Prices," 11 April 1996 (finding that consumers pay higher prices under highly regulated systems of distributing liquor through state-run stores, and as states have relaxed liquor regulation, prices have fallen); available at www.inform.umd.edu/EdRes/Colleges/BMGT/Faculty/JSimon/Articles/LIQRPM.txt.
- ⁸ Institute for Justice, *Uncorking Freedom: Challenging Protectionist Restraints on Direct Interstate Wine Shipments to Consumers*, IJ Litigation Backgrounder (February 2000); available at www.instituteforjustice.org.
- ⁹ Jim Barlow, "Web Ban Law of a Bad Vintage," *Houston Chronicle*, 16 November 2000.
- ¹⁰ Institute for Justice, *Uncorking Freedom*, p. 3.
- ¹¹ *State Board of Equalization v. Young's Market Co.*, 299 U.S. 59, 62 (1936).
- ¹² *Hostetter v. Idlewild Bon Voyage Liquor Corp.*, 377 U.S. 324, 331-32 (1964).
- ¹³ *Bacchus Imports Limited v. Dias*, 468 U.S. 263, 276 (1984). For a comprehensive analysis of the state of the law, see Vijay Shanker, "Alcohol Direct Shipment Laws, the Commerce Clause, and the Twenty-First Amendment," 85 *Virginia Law Review* 353 (1999).
- ¹⁴ www.freethgrapes.org; www.winezone.com/editorial.html; www.wineinstitute.org.
- ¹⁵ *Florida Dept. of Business Regulation v. Zachy's Wine and Liquor, Inc.*, 125 F.3d 1399 (11th Cir. 1997); *State of Florida v. Sam's Wines and Liquors*, 731 So.2d 655 (1st Dist. Fla. 1999); *Dickerson v. Bailey*, 87 F.Supp.2d 691 (SD Tex. 2000); *Kendall-Jackson Winery, Ltd. v. Branson*, 82 F.Supp.2d 844 (ND Ill. 2000); *Bridenbaugh v. O'Bannon*, 78 F. Supp.2d 828 (ND Ind. 1999). The Florida and Massachusetts cases were decided on jurisdictional grounds, and triggered the passage in Congress of the Twenty-First Amendment Enforcement Act. The other cases were solid substantive wins on Commerce Clause grounds.
- ¹⁶ *Swedenburg v. Kelly*, SDNY, No. 00-Civ. 0778 (RMB), 5 September 2000; available at www.instituteforjustice.org/media.
- ¹⁷ Solveig Singleton, "Will the Net Turn Car Dealers into Dinosaurs?" *Cato Briefing Paper*, no. 58, 25 July 2000, p. 2; available at www.cato.org/pubs/briefs/bp58.pdf.
- ¹⁸ Jacob Sullum, "Car Trouble," *Reason Online*, 8 August 2000; available at www.reason.com/sullum/080800.html.
- ¹⁹ Jeffrey Ball, "Auto Dealers, Fearing That Detroit Will Hog The Web, Fight Back," *The Wall Street Journal*, 10 May 2000.
- ²⁰ Singleton, "Will the Net Turn Car Dealers into Dinosaurs?" pp. 2-3.
- ²¹ Jeffrey Ball, "Ford, Auto Dealers Join Forces to Create Web Site," *The Wall Street Journal*, 28 August 2000.
- ²² Singleton, "Will the Net Turn Car Dealers into Dinosaurs?" p. 5.
- ²³ Ball, "Auto Dealers, Fearing That Detroit Will Hog The Web, Fight Back."
- ²⁴ 437 U.S. 117 (1978).
- ²⁵ 439 U.S. 96 (1978).
- ²⁶ Michelle Delio, "Net Smoke Sellers Can Exhale," *Wired News*, 20 November 2000; available at www.wired.com/news/print/0,1294,40269,00.html.
- ²⁷ "Got ID? Verifying Age Online," *The Industry Standard's Food, Web, and Wine*, 16 November 2000; available at www.thestandard.com/newsletters/newsletterBottomframe/0,3679,115,00.html.
- ²⁸ See Kate Marquess, "Sign On the Dot-Com Line," *ABA Journal* (October 2000), pp. 74-76.
- ²⁹ See generally Singleton, "Will the Net Turn Car Dealers into Dinosaurs?"